

DOW THEORY LETTERS INC.

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May 14, DJIA 992.60; PTI 585; A-D Ratio -23.55

BACK: I'm back from the meeting of the Market Technician's Association in Williamstown, Mass. Here are some of my observations. I feel that too many of the technicians (and these were all leading analysts) spend their time examining the branches, the twigs and the leaves while missing the tree. Computers, new indicators, miles of data, complicated mathematical formulas, cycles, all being put to use in an effort to produce exact forecasts. I believe the whole industry would do better if it would spend more time identifying, less time trying to predict. When I asked many analysts what the market was doing today, they seemed strangely disinterested. Many seemed to lack an overall "feel" for what was occurring in Wall Street right now.

In my speech before the technicians I made the point that "neither the duration nor the extent of a primary movement can be predicted in advance." Despite this time-tested Dow Theory adage, it is extraordinary to hear so many analysts putting the demise of the bull market "just before the election" or "in late-1976" or "somewhere in 1977." The fact is that this is still a primary bull market, by my reckoning it is still in its second phase (with a third phase ahead), and there isn't an analyst or a fortune teller alive who knows when it will end.

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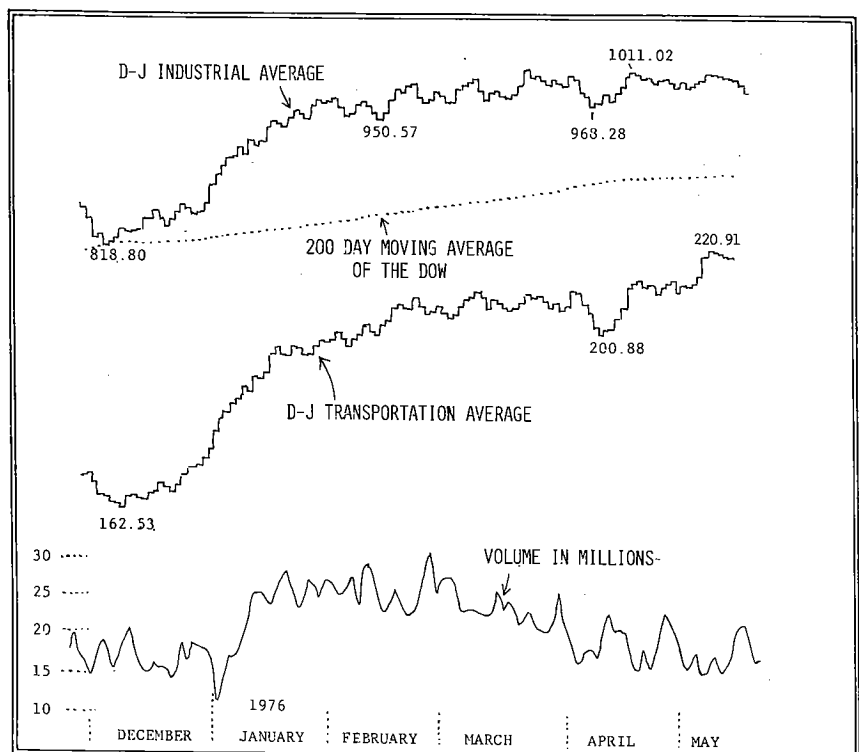
To those who have never driven across the state of Massachusetts, it's an extraordinary experience. You can drive for ten minutes on the Northern state highways without seeing another car. No billboards, little commercialism, lush green hills, rivers and streams everywhere, tiny clusters of old houses, quaint mini-villages. It's like a vision of America a hundred years ago. Nothing is ever torn down in Massachusetts; rickety barns sit there, looking the way they did in 1850. Houses of wood (brick cellars) appear to have withstood the ages. Ancient, ugly brick textile mills now harbor electronic firms or furniture makers. Williamstown is a gem, one of the most beautiful of the eastern college towns. And so—down the Taconic Parkway to NYC.

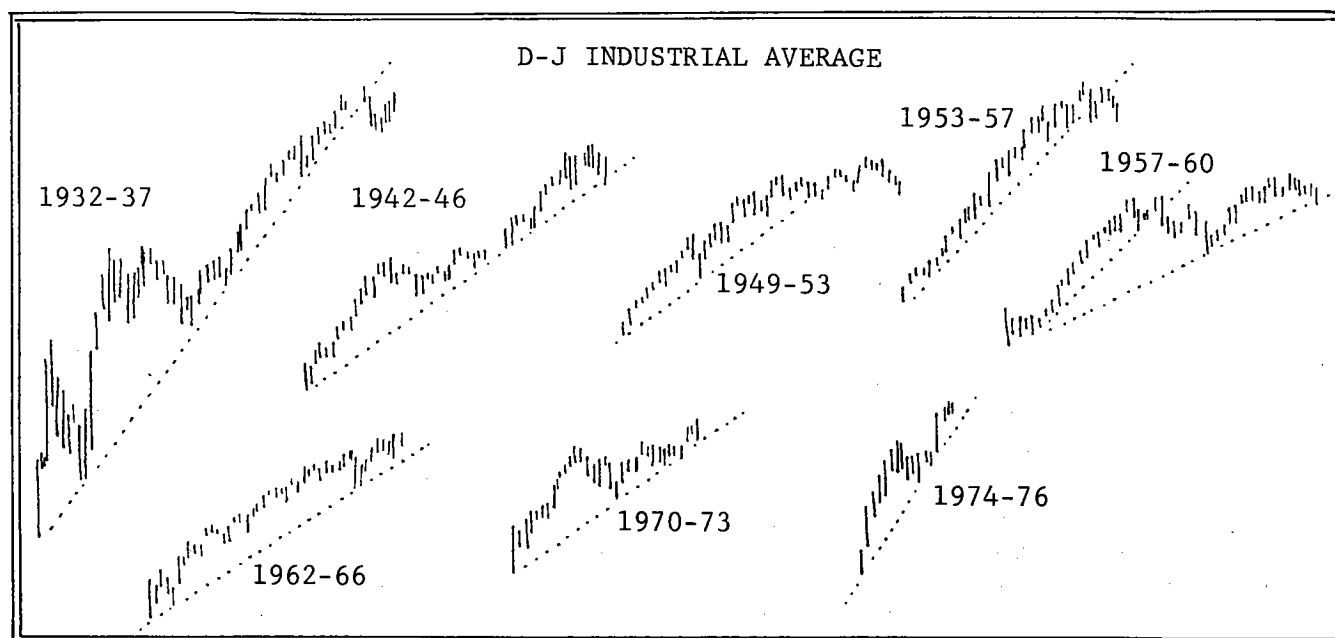
The City (where I lived for 35 years) is the remains of a great monster, jerking and gasping in its death agonies. Black garbage bags line the streets, doormen and elevator men are out on strike, refuse is everywhere. The old fashionable hustle has become the new rip-off. Unless you know exactly where to go, you're going to get "taken" for all they can get. Nothing is free in New York except the air (which probably contains calories) and dear old Central Park (which is now a demilitarized zone).

We stayed at the once-magnificent St. Regis, in a room which cost \$55 per night and would not compare with a \$15 room in any of 50 San Diego hotels. Unfortunately, I didn't know the St. Regis was now a Sheraton (my experience with Sheraton is zero minus). Two sandwiches and a piece of fair cheese cake in a typical NYC deli was \$7.50, and worth maybe half that. At a bar I was charged 50¢ for a glass of seltzer! I claim that the NYC atmosphere, the crowding, the graft, the pressure, the frustrations, all serve to rot mens' souls. And that's why I left the City back in 1960 (when, by the-way, it was a much more liveable place than it is today).

But the greatness is still there. It's in the museums, the intellectual ferment, the big-money excitement, the fabulous retail establishments, the Gucci's, the Bloomingdale's, the Cardin's. Should anyone live in NYC? You might as well ask me whether I should have been a bombardier in WW II. I was a bombardier, and I did live in NYC. They're both memories now, and I would not want to do either again. I survived. And I learned. Which is what life is all about in my humble opinion.

RATE OF RISE: Sometimes the simple, fundamental truths are the ones which escape us. One of the truths which I perceive about this bull market is so simple that I don't think any of my advisory friends have brought it up. It's all laid out for us on the page 2 chart, which I drew up





the day after I got off the plane in San Diego. All right, now don't read any further, just study the chart (which is drawn to ratio scale). It's a chart which pictures all the major advances since 1932. Can you locate the 1976 problem—and the answer?

Here it is: the chart is drawn to semi-logarithmic (ratio scale) so that percentages of all advances or declines can be properly compared. What do we see? We see that the steepest advance in modern history was the bull market rise of 1932-37. None of the other rises since the 1930's were as steep as the great post-crash primary bull market of 1932-37.

Now look at the angle of ascent of the 1974 to present bull market. It's not only steeper than any of the advances of the 1940's, the 1950's or the 1960's, but it's actually steeper than 1932-37! What does that mean? It means that THIS MARKET HAS TO SLOW DOWN. How will it do that? There are only two ways, (1) a downside correction, or (2) a continuation of the current "line formation."

Question: I understand the basic problem which you are illustrating. But which kind of resolution do you expect coming up?

Answer: You're asking me to forecast, and I feel I will be more honest and more helpful if I identify. If we were currently to hold a rising trendline as steep as 1932-37 (and we are, of course, on a steeper course now), then the Dow would have to react to 900 very quickly or move sideways along the 1000 path until about September. If we were to slow down to the more normal 1953-57 rising trendline, the Dow would have to react to 875 within a few months or move generally sideways into the first quarter of 1977.

So far, this market has been trying to hold despite the problem of a Dow trendline which is too steep to be sustained. My guess, assuming the market can retain its current degree of technical strength, is that the Dow will work generally sideways (or perhaps in an even wider trading range), but by year's end we will probably still be in the general Dow area of 950 to 1050. In other words, the BEST thing the market can now do is "kill time." This would gradually slow the rate of ascent of the 1974-76 trendline as shown on this chart.

Question: That's a kind of boring or discouraging formula for the period ahead, isn't it Russell?

Answer: Well, it isn't as exciting as a 200 point Dow rise or a 150 point collapse. But I have tried to deal with the actual technical problem confronting the market (the Dow) at this time. And I have tried to show that it's a problem which is occurring within an ongoing bull market. The fact is that the Dow could be at 900 by December, 1976, and that 900 level would represent the exact rate of ascent which we saw during 1953 to 1957 (which happened to be the period of the second phase of the 1949-66 bull market). The simple truth is that the rise since 1974 has been too rapid. The Dow could now dive to 825 and scare everyone to death, or it could move sideways for nine months and bore everyone to death—and we would still be in a primary bull market.

Question: How about the chances of a big rally from here?

Answer: The longer the market holds within the line, the better the odds for such an advance, but after the advance we would almost surely have a whopping correction, one which would bring the Dow down to a shallower trendline. Such a correction would probably end the second phase of the bull market. Personally, I would rather see the market move sideways from here, perhaps for a number of months (but as readers know, Wall Street seldom arranges itself for Richard Russell's benefit).

A final comment: it is the Dow itself (as opposed to the great majority of stocks) which is out of line on the upside. The fact is that a great many individual stocks have corrected in 1976, even while the Dow has been fluctuating within a narrow range. It's the Dow which now has to slow its progress, and the Dow stocks may therefore retreat while most other stocks tend to hold in the period ahead.

CURRENT MARKET: In the last Letter I wrote extensively about the "line formations" in the Averages. I also stated that in a strong bull market a line can sometimes take the place of a correction.

The market is currently "absorbing" a great many worries. Interest rates have moved up a notch, and the Fed watchers are convinced that the rates are advancing towards the highs again (I am not). Commodity prices are again rising, and the talk is of "double digit inflation" by 1977 (I do not think so). Retail sales have faltered, and we are told that the consumers will never be enthusiastic again (I don't believe it). At any rate, as the worries pour over Wall St. the Averages continue to extend their line formations (rather than diving to important new lows).

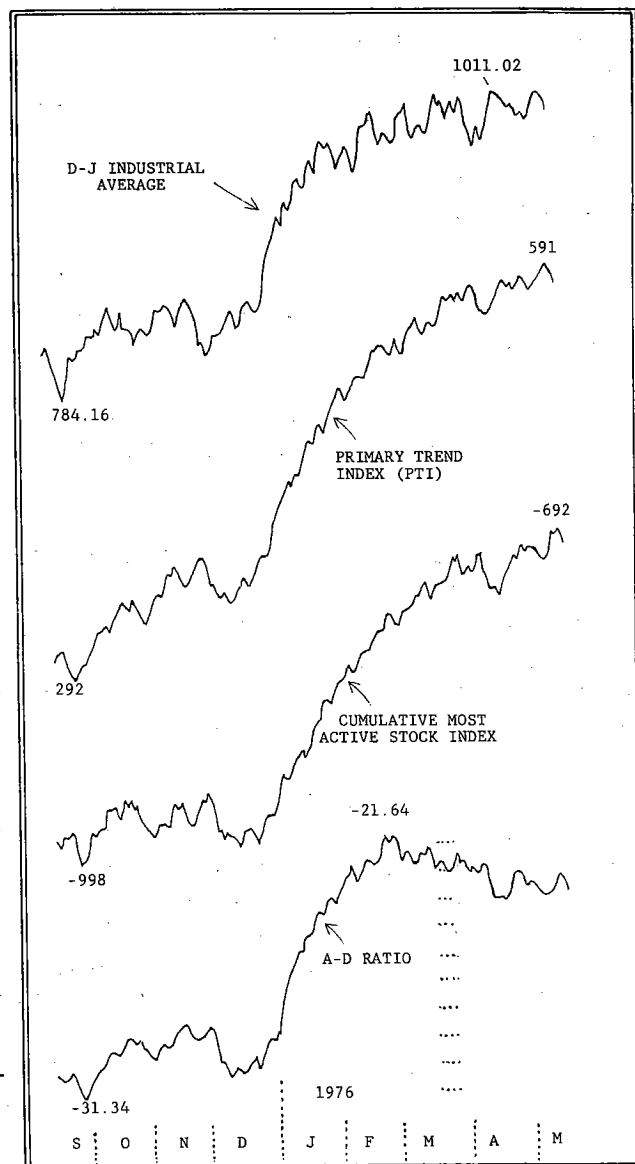
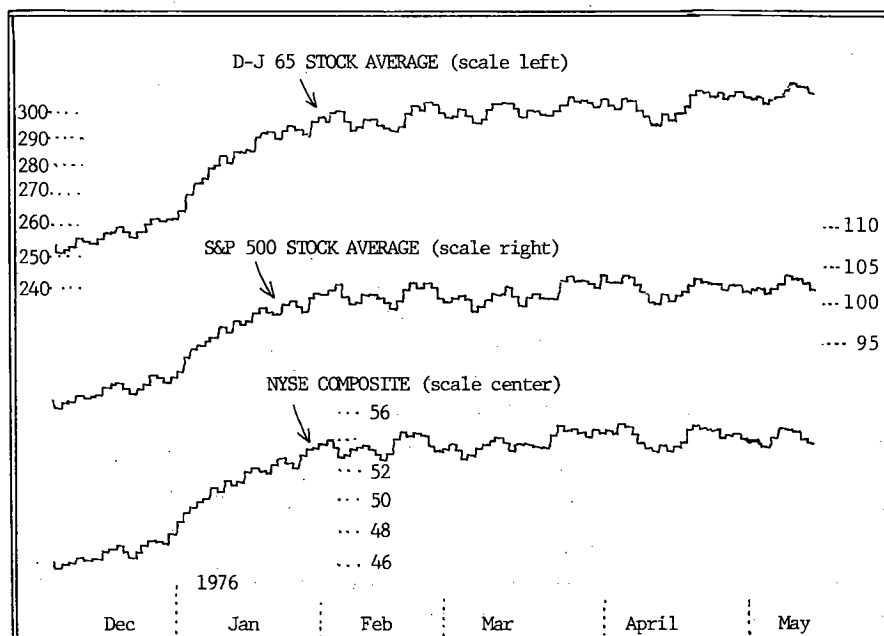
On the D-J Industrial Average the limits of the line are clear, 1011.02 on the upside and 968.28 on the downside (see page 1 chart). On Transports we have an upper line limit of 220.91 and a lower limit of 200.88. Actually, the stronger Transportation Average broke above its previous line limits to record the new May 11 high of 220.91, but since Industrials did not confirm, the rally simply extended the upper limits of the Transport line.

As this is written weakness is again hitting the market, and here it will be most interesting to note whether the Transports will retain their superior relative strength. If they do (and I think they will), then we could get a decline with the Dow perhaps breaking below the lower line limits (below 968.28) with the Transports refusing to confirm. Such action could set the stage for a "downside fooler" and perhaps a final windup to the 1976 frustration.

The current picture seems clearer when we study the chart of the major broad composite averages. I have included this daily graph of the D-J 65 Stocks, the S&P 500 Stocks and the NYSE Composite Index of 1532 stocks. These composites have been moving sideways ever since late-January in the most extraordinary example of line formations in recent history.

On the large chart, we can track some of the more important market gauges. Note that following the Dow peak of 1011.02 (April 21), the Primary Trend Index or PTI (which is made up of eight critical indices) touched a new bull market high of 591 (May 10). On May 12 the cumulative most active stock index (CMAS) hit a new peak. The CMAS is actually an advance-decline index of the 15 most active stocks on the NYSE (plotted daily). Finally, the A-D ratio has been sliding lazily lower ever since February 24. At its April 14 low, the A-D ratio had given up only 2.36 points or 27% of its earlier 1976 gains.

In all, these indicators do not look too bad, considering that the market has been flopping about for almost four months now. The resistance to decline shown by the PTI and CMAS will be an excellent omen if it continues. Watch for the possibility of a downside non-confirmation on the part of the Transportation Average in the event that Industrials break the lower line limit of 968.28. The most bullish downside non-confirmations, I might add, are the ones which arrive amid fear, fear and more fear.



Page 4 **TEST OF VALUES:** Charles Dow, founder of the Dow Jones Company, was a pioneer of the investment field, not only because he started the Wall Street Journal and the first economic news service but because he was one of the first to publicize the concept of values. Although Dow took both earnings and dividends into consideration when appraising stocks and the market, he always gave first consideration to dividends or the "return on investment."

For many years Wall Street has made a fetish of the price-earnings ratio as the key to investment success. This emphasis on P/E ratios came about partly because of the "growth" concept and partly because with high taxes many investors felt that they would rather have their money in a company that plowed earnings back into research or expansion rather than into dividend payout. As we can see from the collapse in many of the so-called glamour stocks during the last few years, this can be a dangerous concept.

Many years ago my friend Fred Whitmore started a market service entitled Investment Quality Trends. IQ Trends has more recently been edited by Geraldine Weiss, and she has carried on the tradition of judging and classifying leading equities on the basis of dividends, dividend trends and relative values (IQ Trends, 5453 La Jolla Blvd., La Jolla, CA 92037).

Recently Fred Whitmore wrote a guest editorial for IQ Trends, one which I read with great interest. Whitmore noted that over any 10-year period a corporation's earnings may be interrupted by such factors as economic recession, strikes, inefficiencies, higher labor costs, etc. Such inroads may temporarily hinder earnings, but they may not necessarily change the long-term path of the given company.

"Cash dividends," notes Whitmore, "are an authentic, negotiable return on investment, while earnings are a wispy, intangible figure, almost exactly what accountants and financial people contrive them to be after such vagaries as depletion, depreciation, tax-loss adjustments, reserves, inventory revaluations, write-offs, and a myriad of other legal bookkeeping legerdemain have taken their toll."

While I don't take the extreme position of Whitmore on P/E ratios vs. dividends, I do believe that over the years a record of dividends will prove more reliable than the price/earnings ratios. For instance, if you were to ask me whether the Dow Industrial Average (as an entity) was a bargain or not, I would immediately think of the total yield and only secondarily of the P/E ratio for the Dow.

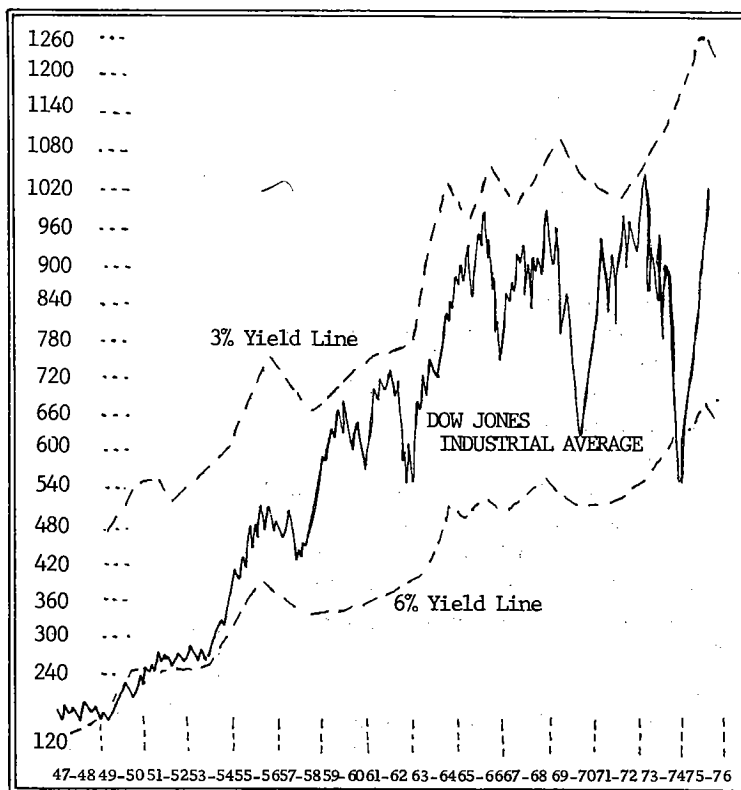
Nevertheless, I would take both into consideration, but only with a knowledge of the history of Dow valuation. For instance, in 1966 the 1949-66 bull market topped out. The Dow yields at the high were only 3%, well within what I consider the danger zone, but the P/E ratio for the Dow during 1966 swung between 13 and 17 times earnings, not unusual or even dangerous as far as the Dow is concerned. In fact, the record high for Dow P/E ratios for the 1949-66 bull market was 23 in 1961.

Following the 1966 peak, the Dow made many upside and downside trips with yields on the Dow at only 4% at the 1966 lows, and only 5% at the 1970 lows. Despite what others thought, I did not believe that 4% or 5% represented the kind of "great values" one should expect at a major bear market bottom.

At the 1974 lows the yield on the Dow rose to 6.5%, the highest level in modern history or since 1950. But here I did use the P/E ratio concept as well. At the lows of 1974, the Dow was selling at 6 times earnings, the lowest level on record (even in 1949 the Dow sold at 7 times earnings). Thus by any standard, I felt that the Dow during the last quarter of 1974 had discounted the very worst. It followed then, that the 30 investment grade Dow Industrials (and a great majority of all the stocks on the NYSE) represented outstanding, once-in-a-lifetime values.

To illustrate the "dividend-value principle," I have drawn a chart showing the Dow Industrial Average going back to 1947. The upper dashed line represents the area of overvaluation, an area which (if touched by the Dow) would provide an average dividend yield of 3%. For instance, in 1973 the Dow actually did touch the 3% zone, just prior to its collapse.

The lower dashed line represents the zone of great value. Whenever the Dow came down to touch the lower zone the average Dow yield would rise to the 6% area. Note that all during 1949 to 1953 (the first phase of the 1949-66 bull market) the Dow traveled in or near the 6% zone. So the yield principle was fairly shouting "great values" at the beginning of that bull market. At the 1974 low the Dow plunged below the lower dashed line as the Dow yields climbed to 6.5%. Thus, for the first time since 1949 and the very early 1950's, the Dow (in 1974) was providing outstanding value.



For the four quarters ending December 31, 1975, the Dow dividends amounted to \$37.46. They will probably climb during 1976, but even at the late-1975 basis the Dow would now have to climb to 1248 to reach the 3% dividend basis. This is illustrated on the chart. It is obviously not a prediction. But it is a guideline, since we know that when a primary bull market moves into its third phase (the final, speculative phase), prices tend to rise to a zone of overvaluation. At that time, amid third phase enthusiasm, I would expect the Dow to climb toward the upper dashed line on the chart.

Another chart (at right) which I feel offers much food for thought is the one showing the price of the D-J Industrials as a multiple of total Dow Industrial dividends. The chart provides great perspective since it goes back to 1920 (chart courtesy of M/G Financial Weekly).

Note that the very low end of the multiple is about 10. This low valuation for Dow dividends was seen only during 1932 and during 1942 (at the depth of World War II). The high end seems to be around 30 to 35, an area touched in 1946 and all during the inflationary 1960's and into 1973. At the late-1974 bear market bottom, the multiple dropped to around 16, the lowest level since the early 1950's (at which time the 1949-66 bull market began).

What of today? Figuring Dow dividends at about \$37.50, the multiple got up to about 27 at the recent bull market high of 1011. Thus it would seem that the Dow got a bit ahead of itself in terms of dividend multiples. And it is just as clear that from here on, much will depend on the ability of the Dow stocks to produce increasing profits and thus raise dividends. For instance, if Dow dividends rise to \$40 and the multiple rises to 30 (which it has done many times since 1960), then we could see 1200 on the Dow. At any rate, that will give us some idea of the dividends-valuation principle and the problems the market faces as it moves along in this continuing bull market.

SUNDRY MARKET COMMENTS: The big even numbers often exert a mysterious influence on Wall Street. For instance, a stock or an average often finds support or resistance at the 50 or 100 or 500 levels. Once penetrating those levels, the price movement may make major swings in the direction of the penetration.

I find it particularly interesting to note that at the current juncture the following big even numbers have been penetrated and these Averages are (so far) holding above the penetration levels. (1) NYSE Composite a few points above 50. (2) NYSE Financial Average 1 point above the 50 level. (3) S&P 500 Stock Average a few points above the 100 level. (4) D-J Transport Average now about 20 points above the 200 level. (5) D-J 65 Stock Average a few points above the 300 level. (6) D-J Industrial Average just below the 1000 level (and, of course, this has been the problem indicator for the market).

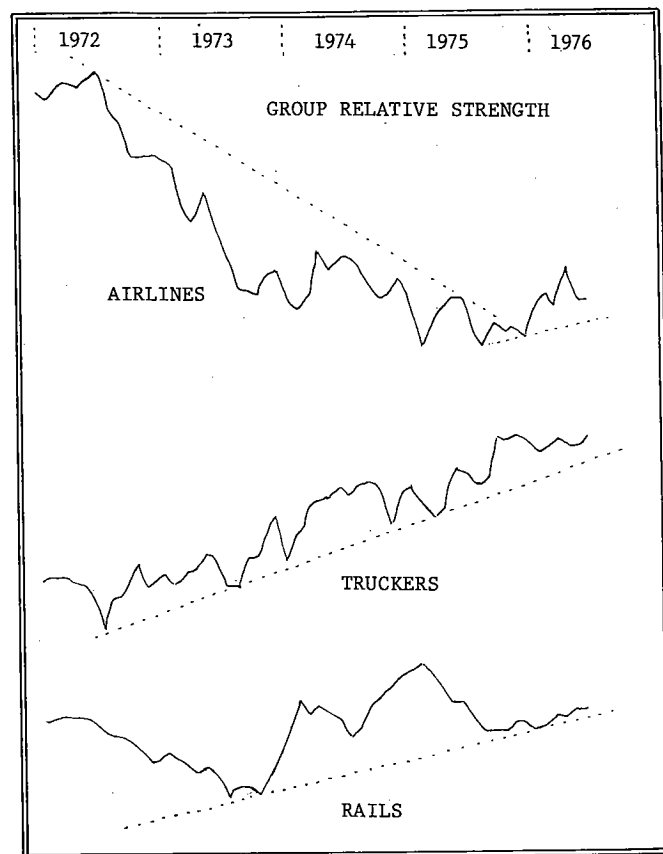
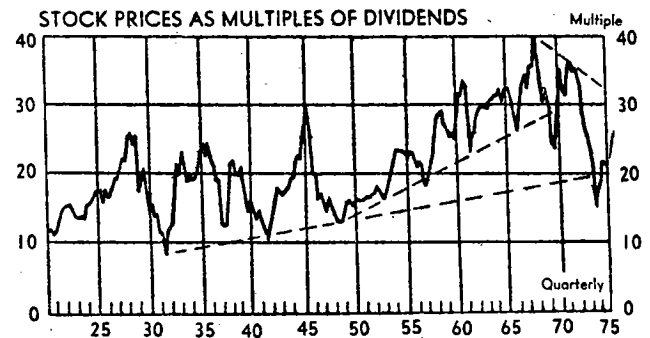
If the majority (or all) of the Averages above can consolidate and hold above those even levels, it will, in my opinion, be very bullish for the market. Obviously, a breaking below the big numbers by the Averages will be bearish.

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Although the D-J Transportation Average is made up of more rail stocks than airlines or truckers, it is nevertheless interesting to break the Average down into its components in terms of relative strength. Note on the chart that both the truckers and the rails have been acting better than the general market ever since 1972. The airlines, on the other hand, showed poor relative strength (RS) all during the 1972-75 period until the end of 1975.

But the four year decline in airline RS was reversed in late-1975, which means that all the Transportation Average components are now acting better than the general market. This is being demonstrated almost daily as the Transports outperform the Industrials. And strength in the Transports continues to belie weakness in the Industrials.

GOLD: My gold stance continues to be the same. I believe that the price of bullion probably hit its bear market low at 124.60 or January 20, and I believe the majority of N.American gold shares hit their bear market lows in 1976. The S. Africans remain the mystery. Many of the Kaffirs broke above their recent major downtrend lines during the April-May rally, but some (like weak-

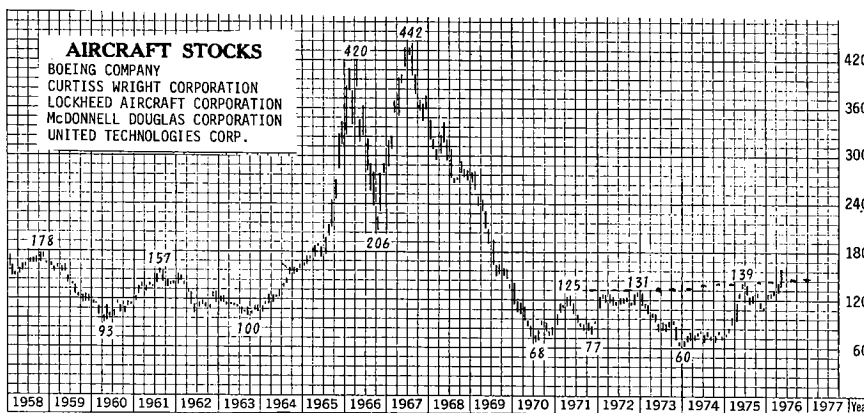


acting Vaal Reefs) did not. This chart of West. Drief. (courtesy of Kaffir Chart Service, Palisades Pk, NJ 07650) shows what happened in the majority of cases. Watch this bellwether stock. If it can now move above 32 the S. African gold picture (technically) will look a good deal better, and a bottom may have been formed.

Nevertheless, with Rhodesia facing continuous (and escalating) black-white confrontation, with S. Africa saying "no" to supplying Rhodesia with arms, the political problems grow fierce. S. Africa is obviously trying to walk a tightrope, hanging on to apartheid on the one hand but playing "Big Brother" to Rhodesian blacks on the other. All this in hopes of convincing the blacks that S. African whites are the "good guys" and the Rhodesian whites are the "baddies." Meanwhile, Kissinger is shouting "black power" and placing US corporations' multi-billion dollar S. African investments in a state bordering between utter confusion and ultimate jeopardy.

I get a helluva lot of news from S. Africa. I have subscribers on both sides of the color line, some who live in S. Africa, some who visit there constantly. The whites tell me that all is well, and that S. Africa could take on the whole continent anytime. The black word is that the fire is coming, but that it could be as long as five to ten years away. Conclusion: if any subscribers can come up with a conclusion to the S. African problem, I'd love to hear it.

STOCKS: The Aerospace Group, which turned up in relative strength (RS) in mid-1974, is taking off again. Aerospace and defense stocks dot the new high lists. I am including this group chart (courtesy of Horsey, Salisbury, MD 21801) showing the tremendous six-year base in the Aircraft Stock Group, and also the massive "head-and-shoulders" bottom in the group. The upside breakout from the bottom is occurring now. The five stocks which make up the group are listed on the chart. I have previously recommended Litton, and add General Dynamics and Northrup as outstanding actors in the Group.



I wrote quite a bit about the US and food in the last two reports. Ironically, almost everything connected with food seems to be topping out as far as RS is concerned. The Retail Food Group is in a bearish RS trend. The Restaurant Group has also reversed to the downside in RS, and it has been joined by the Hotel-Motel group. I ask myself what's happening. Has the "going out to eat" explosion reached its zenith? Have Americans decided that they can cook better chow at home? Are Americans buying cars but not driving them to Holiday Inns and Howard Johnson?

My personal guess is that maybe they're overdoing the whole franchise bit, both on Wall Street and everywhere else. We have corners in San Diego that have so many franchises on them, they wook like a Madison Avenue nightmare. A friend of mine predicts that in ten years the entire nation will be covered with a thick layer of banks, freeways, graveyards and hamburgers.

On the new upward reversal list for RS this month are Gulf Oil, Standard Oil of California, Wells Fargo and S. Louis S. Francisco Ry. On the downward reversal list are Gulf & Western, Holiday Inns, Howard Johnson, Burlington Industries, Scott & Foresman (RS changes courtesy of Ray*Signals, 43 Montrose, PA 18801).

COMPOUNDED GROWTH: Broker: "Hey Moe, I've got something for you. It's a great growth situation and that's the reason it only yields 1% a year. But get this: I'll guarantee that it will appreciate another 8% each and every year. Interested in a number like that?" Moe: "Darn right I am, but what is it, some sort of funky Brazilian Telephone stock?" Broker: "Are you kiddin', it's a high-grade bond fund. Pays you 9% a year, m'boy, but look at it this way. Tell yourself you're getting 1% a year with 8% 'growth', and it sounds pretty fascinating, doesn't it?" . . . (Of course, the foregoing is not strictly true unless you are in a low income bracket or unless it applies to a pension fund--because the 9% is taxable. However, the public is becoming increasingly attracted to bonds, and why not! The power of compound interest, as I've said over and over, is phenominal--at 9% money doubles in less than 8 years).

It's about time for a smile, and this item (it's real) from the Overseas Weekly should do the trick.

Next Mailing: May 28th

George Washington arrested Richard Nixon on a drug charge in Pittsburgh's Homewood section. Officer Washington said he arrested Nixon, 19, on a theft charge and found four packets of suspected marijuana on the suspect. A deskman at No. 5 Police Station said it was a shame Washington's partner was not in one the arrest. His partner's name is Benjamin Franklin.

